MARKET OUTLOOK

JANUARY 2010

Equity prices rebounded nicely in 2009, rising 60% off their March lows which brought the total gain for the year, as measured by the S&P 500, to 26.5%. However, the last calendar decade was the worst ever for stock prices as they declined at a 1.0% annual rate. On the other hand, the previous decade of the nineties was the best calendar decade on record with stocks up at a 17.6% average annual rate. Looking ahead, the consensus is that stocks are positioned for further gains as the recession has ended. GDP grew in the third quarter and should expand in the fourth quarter, while short-term interest rates are at record lows, inflation is tame, and profits are growing.

So far, the economic expansion is modest and has been heavily dependent upon government spending and other stimulative measures. Therefore, a critical variable will be the pace of the expansion and how the economy will manage as government stimulus is slowly withdrawn. The pace of the expansion will go a long way in determining how quickly the unemployment rate declines, which in turn will heavily impact consumer confidence. Companies have adjusted to the recession with lay-offs and reducing existing staff hours. Of concern is that a modest expansion would only increase existing workers' hours and not lead to additional hiring and a lower unemployment rate.

Last year's unprecedented sharp rebound in stocks suggests that prices are discounting a strong expansion and a 20% plus gain in corporate profits. The risk to further strong gains in stock prices is that the recovery will be more modest than expected because of the unusual headwinds, such as record levels of federal, state and local debt; very high numbers of houses for sale or to be sold through foreclosure; very low personal savings rates; and weak consumer balance sheets which must be rebuilt. In addition, the economy faces the prospect of increased government regulations in attempts to control carbon dioxide and the increased uncertainties evolving from a greater federal role in the healthcare system. Furthermore, it is almost certain that tax rates will rise by 2011.

Perhaps the most important unknown is the future of domestic inflation. In order to limit the damages to the economy and the financial markets from the Great Recession of 2008-2009, the federal government provided massive amounts of monetary and fiscal stimulus. This has resulted in very elevated levels of federal debt and of the money supply, both of which will have to be reduced.

If the Federal Reserve is not successful in withdrawing this monetary stimulus, the U.S. faces the prospects of accelerating inflation and interest rates in two to three years. For now, inflation is not a factor because of excess supply of labor and manufacturing capacity.

Given the above average level of fundamental uncertainty, both in the U.S. and abroad, stock prices are expected to be highly volatile. In this environment, we will attempt to take advantage of price swings while continuing to manage portfolios carefully; stressing asset preservation, quality, diversification, and balance.

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